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Foreign Personal Holding Company Income of Controlled Foreign Corporations

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ment[176] to section 357(c)(1)(B) to apply to the non-liquidating reorganization where assumed liabilities are permitted consideration for the exchange. In this way a negative basis would be avoided and there would be no need to tax a corporation unless it was going to remain in existence.

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FOREIGN PERSONAL HOLDING COMPANY INCOME OF CONTROLLED FOREIGN CORPORATIONS*

INTRODUCTION

United States persons[1] who control foreign corporations generally are entitled to permit such corporations to accumulate wealth without directly or indirectly bearing the burden of United States income taxes. Neither foreign corportions nor their shareholders are ordinarily subjected to current United States taxation on corporate income. This advantageous treatment is commonly referred to as the deferral privilege.[2] The rationale for this policy combines traditional legal respect for corporate identity with an economic justification which argues the impropriety of taxing alien entities on income which has no nexus with the United States. Additionally, the policy seeks to avoid the alleged competitive disadvantage which would result if the United States were to tax United States enterprises operating through foreign subsidiaries while other industrialized nations imposed no equivalent burden on their citizens.[3]

Of course, when corporate earnings are repatriated to this country, United States taxpayers may be required to report such amounts as income[4] unless avoidance is possible in whole or in part through other opportunities provided by the Code.[5]

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176. Note that the committee's recommendation to amend §357(c) and §358(d) would not alter the meaning of "liabilities" under §357(a) and §357(b). *Id.* Neither would the amendment extend to §361 transactions, in particular the "D" reorganization, to the extent it does not also qualify under §351. The meaning of "liabilities" under §357(c)(1)(B) would continue under present law. Congress, in the Revenue Act of 1978, adopted the committee's proposal and amended §357(c) by adding §357(c)(3), §358(d) and §358(d)(2).

*This article is a segment of a six-person project designed to examine the four components of foreign base company income and related problems involving corporate accounting. The other five papers are on file at the office of the Graduate Tax Program of the University of Florida College of Law.

1. *See* I.R.C. §7701(a) (130). *See also* I.R.C. §957(d).

2. *See* 109-2d TAX MNGM'T (BNA) A-1 [hereinafter TM-109]; B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶17.30 (3d ed. 1971).

3. *See* L. Lokken, U.S. Taxation of International Transactions 127-9 (1977) (unpublished materials for use of students in the Graduate Tax Program of the University of Florida College of Law, rights reserved) [hereinafter cited as L. Lokken]. *See generally* H.R. REP. No. 1447, 87th Cong., 2d Sess., 1962-3 C.B. 405, S. REP. No. 1881, 87th Cong., 2d Sess., 1962-3 C.B. 405, CONF. COMM. REP. No. 2508, 87th Cong., 2d Sess., 1962 C.B. 1129.

4. I.R.C. §61(a)(7).

5. Sections 116 and 243-245 (I.R.C. §§116, 243-245) do not ordinarily apply to dividends received from foreign corporations which do little or no business in the United States. There

Prior to 1962, there were only two significant restrictions on the deferral privilege, the sourcing rules and limitations imposed on the income of foreign personal holding companies (FPHCs).[6] In 1962, Congress added a third limita-

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are, however, other means of tax free repatriation. For example, a foreign corporation may make loans from its accumulated earnings to its shareholders or to lower tier subsidiaries without current tax consequences. Thus, deferral can approximate permanent avoidance, the best of all possible worlds. *See,* H. Caudill, Subpart F Earnings and Profits 2 (1978) (unpublished paper on file at the office of the Graduate Tax Program of the University of Florida College of Law).

6. The sourcing rules (I.R.C. §§881-882, 861-863) subject a foreign corporation to the United States corporate rate or to a flat 30% tax on certain income derived from United States sources. This exception is considered appropriate because the taxing authority is the government under whose laws business is conducted and income is earned. Economic activity attracts a tax which is measured in terms of the profitability of the activity.

The policies underlying the tax imposed on the income of foreign personal holding companies are somewhat more complex, but are important for purposes of this article. Certain shareholders of closely held foreign corporations are taxed directly and currently on corporate income whether or not such income is distributed. Inclusion is mandated and measured by Part III of subchapter G (I.R.C. §§541-547). Although disputed, the constitutionality of taxing shareholders on undistributed income has not been successfully challenged. The Tenth Circuit Court of Appeals has recently held that such taxation is constitutional, at least when the shareholders belong to a unified group in control of the corporation. Whitlock v. Commissioner, 494 F.2d 1297, 1301, 1974-1 U.S. Tax Cas. ¶9388 at 83,937 (10th Cir. 1974), *cert. denied,* 419 U.S. 839 (1974). *See* Eder v. Commissioner, 138 F.2d 27, 1943-2 U.S. Tax Cas. ¶9519 (2d Cir. 1943). The rationale seems to parallel that underlying the constructive receipt doctrine. *See* H. Caudill, *supra* note 5, at 4.

The decision by Congress to tax currently the earnings of foreign personal holding companies is the result of the potential for abuse of the corporate form that such devices offer wealthy taxpayers. Corporations are recognized as legal entities because such a policy serves the public interest by encouraging commercial activity and investment. The corporate form creates a stimulus for the accumulation of capital by limiting the risks and liabilities of shareholders, as well as by providing for centralized management of complex enterprises. H. HENN, LAW OF CORPORATIONS (2d ed. 1970), 37-42. The §11 tax rates reflect a corollary federal policy. Investors are permitted to defer the §1 tax on corporate earnings as long as those earnings are left within the corporate shell, available for reinvestment. The §11 tax represents the tax cost, both for the use of the form and for the deferral option. *See* Morrissey v. Commissioner, 296 U.S. 344, 1936-1 U.S. Tax Cas. ¶9020 (1935); Commissioner v. Smith, 136 F.2d 556 1943-1 U.S. Tax Cas. ¶9477 (2d Cir. 1943).

Underlying this governmental solicitude is the fundamental assumption that corporations are to be the means of conducting an active enterprise. The tax benefit afforded the corporate entity is less justifiable when the corporate shell does little more than provide a tax shelter and serves no further business purpose. This is likely to be the case where the corporation's assets consist of passive investments, which in themselves insulate the investor from the unlimited risks inherent in the active conduct of an enterprise. Such entities are commonly known as holding companies. Congress determined that the abuse was especially acute when the corporation was closely held, representing little more than an incorporated investment portfolio for its few shareholders. *See* H.R. REP. No. 1546, 75th Cong., 1st Sess., 1937-2 C.B. 609; Marsman v. Commissioner, 205 F.2d 335, 340, 1953-1 U.S. Tax Cas. ¶9431 (4th Cir. 1953). *See also* T. NESS & E. VOGEL, TAXATION OF THE CLOSELY HELD CORPORATION, 6-1 to 6-2 (1976). More pragmatically, widespread use of such devices would have an adverse impact on the government's revenues. The weakness of the economic justification for permitting deferral of §1 taxes on passive income, combined with a threat of substantial revenue loss, prompted Congress to limit the deferral potential of both domestic and foreign personal holding companies. This legislation reaches only a relatively narrow and arbitrarily defined group of corporations. Both

tion, a series of Code sections which now comprise Subpart F of Part III, Subchapter N (Subpart F).[7] Subpart F identifies certain items of corporate income and includes them under the heading Subpart F Income.[8] Subpart F Income is attributed pro rata to certain shareholders[9] of corporations which have been identified as controlled foreign corporations (CFCs).[10] As is the case with FPHCs, inclusion results to the shareholder whether or not income is actually distributed currently.

To most, Subpart F presents a crazy-quilt of interrelated provisions and incomprehensible regulations. Boris Bittker, a leading expert in the field of corporate taxation, has written: "In an effort to cover every contingency, the rules of Subpart F reach and never leave a lofty plateau of complexity that the Internal Revenue Code had previously attained only in occasional subsections, although in the end it turns many tasks over to the Treasury to discharge by regulations."[11]

Subpart F is aimed primarily at certain kinds of artificially structured transactions called tax haven manipulations.[12] Prior to the enactment of Sub-

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provisions were originally enacted in Title II of the Revenue Code of 1937. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at ¶¶17-20. In general, the operative rules engage only when a foreign corporation (1) receives 60% or more of its gross income in a form characterized as passive under §553; and (2) is controlled by a group of United States shareholders consisting of not more than five individuals. Stock attribution rules of §554 expand the actual size of the United States group. Congress nevertheless originally concluded that the most serious abuses would be eliminated.

The limitation on deferral imposed by III-G should therefore be understood as an extension of revenue policies applicable to domestic holding companies. Foreign personal holding companies are swept into the scheme to prevent avoidance of the rules applicable to domestic holding companies through the simple expedient of offshore incorporation. There is an interrelationship of scope and policy between the personal holding company statutes and §954(c), which sweeps items of passive income into the Subpart F scheme. It is therefore not surprising to find that the rules of inclusion for Subpart F foreign personal holding company income incorporate the regulations responsive to III-G, which in turn lead back to the core of the overall structure, the regulations dealing with domestic holding companies.

7. I.R.C. §§951-964.

8. I.R.C. §952.

9. For purposes of Subpart F, only substantial shareholders face the threat of taxation. Only "United States shareholders" are subject to the inclusionary rules. (I.R.C. §951(a)(1)). A United States shareholder is defined by I.R.C. §951(b) as any "United States person" (defined in I.R.C. §957(d) to include both natural persons and corporations) who owns or who is considered as owning under the attribution rules of I.R.C. §958(a) & (b) 10% or more of the combined voting power of a corporation. *See* TREAS. REG. §1.951-1(g) (1965).

10. *See* I.R.C. §957(a). In general, a CFC is a foreign corporation if more than 50% of the total combined voting power of its stock is held by a group of United States shareholders, as defined by §951(b). See note 9 *supra*. The attribution rules of §958(a) & (b) are also applicable in testing to determine whether such a United States group exists. See note 9 *supra*.

11. B. BITTKER & J. EUSTICE, *supra* note 2, at ¶17.31.

12. *See* B. BITTNER & J. EUSTICE, *supra* note 2, at ¶17.32; TM-109, *supra* note 2, at A-2 & 3. The term "tax haven" is one which has come into the vernacular of the ordinary attorney and even the general public, but it is not always clearly understood. The term can be used in two senses. As used by the general public, it often incorporates a pejorative connotation of commercial prostitution on an international scale. There are countries such as Panama, the Kamin Islands, and Luxemburg, which impose no income tax on income earned by native corporations, and which actively encourage foreigners with large investment portfolios to

part F, critics of the deferral privilege pointed to instances in which a United States controlled foreign corporation could consciously and often artificially structure transactions to avoid all or substantially all income taxes.[13] The following are simple illustrations of how this could be accomplished.

1. X is a corporation of country A. A taxes residents and nonresidents at an equal rate, but only on income which has an economic nexus with A. X engages in securities trading on the stock market of country B. Country B does not tax foreign corporations on sales of personal property within B unless they maintain a permanent establishment in B. X has no permanent establishment in B, instead trading through a broker. B does not tax X on gains realized on the sale of securities within B, and, since A imposes no residual tax, X pays no tax at all on this income.

2. X corporation of country A, the same corporation in 1 above, is paid interest on securities issued by a corporation in country C. Country C imposes a tax on interest earned by foreign corporations within C, but if the foreign corporation does not engage in a trade or business or maintain a permanent establishment in C, the tax is imposed at a flat rate of 30 percent. Since the interest has no economic nexus with A, the tax paid by X on this interest income is a flat 30 percent.

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transfer these intangibles into such countries, using tax benefits as incentives. Such encouragement can be viewed as an invitation to avoid taxes through artificial manipulations, a course of conduct which is viewed as immoral in some quarters. There is, however, a broader sense in which the term tax haven has meaning, and it is in that sense in which it will be used here.

Nations adopt various philosophies about the proper situs and manner of taxing economic activity. The United States has, in general, adopted the view that its citizens should pay tax on their worldwide incomes, and attempts to alleviate double taxation on the international scene through a complex set of exemptions and credits. *See, e.g.*, I.R.C. §§901-912. Other nations quite properly adopt the view that only the nation in which economic activity occurs is a proper situs for an income tax, and hence impose no residual tax on income. In many cases, however, the situs of economic activity is not easy to discern. This is especially true in the case of sales of property, but the problem can also arise in the case of shipping, services, and insurance, to name only a few areas. Whenever the taxing authority of one nation defers to another, and second nation chooses not to exercise that authority, avoidance potential is created. The second country becomes a tax haven for residents of the first. Congress aimed Subpart F at practices devised to permit income to slip through these cracks in international taxation.

13. *See* L. Lokken, *supra* note 3, at 127-29; TM-109, *supra* note 2, at A-2 & 3. The arguments in support of deferral have been mentioned previously. There is, however, a school of thought holding a contrary view. A number of respected economists and political figures, including President Kennedy and tax expert Stanley Surrey, have argued that, rather than fostering competition, deferral actually discriminates against investment within the United States and intensifies internal unemployment, balance of trade, and balance of payments problems. In 1961, President Kennedy submitted a proposal to Congress which would have effectively eliminated the deferral privilege. This proposal was vigorously opposed by United States business interests that would have been adversely affected. The outcome was a compromise Congress hoped would curb abuses, but which otherwise preserved the deferral privilege for ordinary United States businesses operating abroad. The attack on deferral has not abated. President Carter appears to share the Kennedy-Surrey view and has suggested that deferral be eliminated. In addition to the old arguments against deferral, there is further criticism that the 1962 compromise is so complicated that it is understood only by a handful of corporate giants which can afford sophisticated tax counsel. It is difficult to quarrel with this latter criticism. *See* TM-109, *supra* note 2, at A-2 & 3; H. Caudill, *supra* note 5, at 44-46.

Rather than totally eliminating deferral, however, Congress has attacked only what it considered abuses of the privilege.[14] Section 954[15] identifies four items which are ultimately to be included in Subpart F Income. These four items comprise a sub-category called foreign base company income. Three of the components, sales income,[16] services income,[17] and shipping income,[18] are clearly attempts to eliminate definite categories of tax haven manipulations. The fourth component, foreign personal holding company income (FPHCI),[19] is a migrant from another subchapter[20] and is seemingly misplaced. Inclusion of FPHCI in foreign base company income reflects a fundamental concession to the opponents of deferral, and one that rests on broader policy considerations than those which underlie the other elements of foreign base company income. As has been noted, the strongest argument supporting deferral is the need to protect the competitive standing of American enterprises operating through foreign subsidiaries.[21] Since passive investments are not subject to the same competitive forces, Congress would have been justified in extending the policy determinations of III-G to CFCs, even if transactions involving investment portfolios were not subject to manipulation.[22] The manipulations that were known to occur simply strengthened the argument for withdrawing the deferral privilege from this particular kind of income.

Subject to exceptions to be discussed later, section 954(c) would mandate inclusion in FPHCI of the income earned in both of the examples outlined above. Subpart F requires that United States shareholders[23] of a CFC that earns a substantial amount of FPHCI and is taxed on such income at rates lower than those applicable to a United States corporation must take a ratable part of such earnings into their income currently.[24] These shareholders recognize such income as constructive dividends.[25] If the shareholder is a corporation, the tax will be imposed at the section 11 rate; if the shareholder is an individual, the

14. S. REP. No. 1881, 87th Cong., 2d Sess., 1962-3 C.B. 707.
15. I.R.C. §954.
16. I.R.C. §954(a)(2), (d); TREAS. REG. §1.954-3 (1964).
17. I.R.C. §954(a)(3), (e); TREAS. REG. §1.954-4 (1964).
18. I.R.C. §954(a)(4), (f); PROPOSED TREAS. REG. §1.954-6, 41 Fed. Reg. 154 (1976).
19. I.R.C. §954(a)(1) & (c); TREAS. REG. §1.954-2, T.D. 7497, 1977-33 I.R.B. 18.
20. Part III of Subchapter G. See note 6 *supra*.
21. See text accompanying note 3 *supra*.
22. Such income will be subject to tax, however, only if the aggregate of taxes paid to foreign governments by a CFC is substantially less than the United States rate which would have been paid had the corporation been organized in the United States. I.R.C. §954(b)(4). It is interesting to note that the Treasury adopts the United States tax rate as the point of reference for the application of this provision. *See* TREAS. REG. §1.954-1(b)(3)(ii), T.D. 7293, 1973-2 C.B. 228. For other items of foreign base company income, the reference point is not the United States rate but the rate at the situs of the economic activity which generates the income. *See, e.g.*, TREAS. REG. §1.954-1(b)(3)(iii), T.D. 7293, 1973-2 C.B. 228. The effect is a presumption that, in any circumstance in which the tax paid on an item of FPHCI is below the United States rate, that a significant purpose of creating the CFC and routing the transaction through it was a substantial reduction of income tax.
23. See note 9 *supra*.
24. I.R.C. §951(a).
25. I.R.C. §951(a)(2); TREAS. REG. §1.951-1(a), T.D. 7293, 1973-2 C.B. 228.

income will be taxed under section 1. As a result, the foreign shell offers no deferral potential. The income is taxed as if it were distributed as earned.

This article attempts a thorough analysis of the rules of inclusion pertaining to FPHCI and will discuss in detail several complex exceptions to those rules.[26] Most of the complexities encountered with respect to FPHCI relate to exceptions applicable to interest, dividends, gains from securities transactions, and amounts received from related persons. These subjects are discussed in depth. Other items of inclusion, such as annuity payments, amounts received from estates and trusts or for the use of corporate property by certain shareholders, are straight carry-overs from III-G and presumably are of rather limited significance to most CFCs. They therefore will receive less extensive analysis.

ITEMS OF FOREIGN PERSONAL HOLDING COMPANY INCOME

Subpart F borrows its definition of FPHCI from section 553.[27] Section 954(c) and the regulations tailor the section 553 rules of inclusion[28] to fit the two-pronged goal of Subpart F to deny tax deferral to the income of United States controlled foreign corporations that is unrelated to the conduct of an active trade or business or which is the product of tax haven manipulation.[29] Section 553 lists seven classes of passive income including dividends, interest, rents, royalties, net gains from the sale of stock and securities and net gains from commodities transactions.[30]

Section 553(a)(1): Dividends, Interest, Annuities, and Royalties

Dividends. Dividends are a common source of passive income. The general rule of section 954(c) (via section 553) requires that they be included in

26. Other exceptions, which relate to foreign base company income as a whole, will not be discussed. *See, e.g.*, I.R.C. §954(b)(3) & (4), or I.R.C. §952(b).

27. I.R.C. §553; TREAS. REG. §1.954-2(a) (1964). The regulations under §553 incorporate the regulations responsive to §543, which defines the term personal holding company income for the purpose of identifying domestic personal holding companies.

28. Once a corporation has been identified as a foreign personal holding company, its entire undistributed net income (UDNI) is subject to tax, despite the fact that up to 40% of its earnings may be of an active character, that is, other than FPHCI. I.R.C. §§551, 552, 556; TREAS. REG. §1.553-1, T.D. 6739, 1964-2 C.B. 156.

The process of identifying FPHCI always begins with §553. Since the FPHCI label is attached to items of income as a part of the process of classifying the income earning entity as a foreign personal holding company, the label is somewhat misleading. It is important to remember that elements of FPHCI are identified as such because of their passive nature, not because the entity earning the income is necessarily a foreign personal holding company. Any foreign corporation which receives, for example, interest or dividends which do not fall within an exemption has FPHCI.

The fact that the same income items are subject to inclusion for two separate segments of the Code immediately suggests a problem with double taxation. Subpart F deals with this problem by providing that, in any case in which the same income is includible in the income of a United States shareholder both under Subpart F and under III-G, Subpart F gives way. I.R.C. §951(d); TREAS. REG. §1.951-3 (1965).

29. I.R.C. §954(c)(2), (3) & (4). See S. REP. No. 1881, *supra* note 14, at 3381-82; L. Lokken, *supra* note 3, at 127-32.

30. I.R.C. §553.

FPHCI.[31] The meaning of the term dividend is the same as that found in Subchapter C, a distribution by a corporation from its current or accumulated earnings and profits to its shareholders with respect to their stock.[32]

Because a foreign corporation could shield itself from passive income by simply transacting business through lower tier subsidiaries that retained their earnings rather than distributing dividends, both Subpart F and III-G require attribution of the current earnings of such subsidiaries to the entities that control them. Section 553 creates a special class of "presumptive" or constructive dividends[33] consisting of the undistributed net income of a foreign subsidiary of a foreign corporation when the subsidiary has been identified as a foreign personal holding company.[34] Presumptive dividends are included in income ratably by any foreign corporation owning stock in a foreign personal holding company as if a dividend had actually been distributed.[35]

Subpart F adopts a different approach to the problem presented by lower tier subsidiaries. A ratable part of Subpart F income from a foreign subsidiary that is a CFC will be attributed directly to its group of United States shareholders without resorting to the additional fiction that such income passes through its foreign parent.[36] Requiring the parent to include such amounts in its own FPHCI would ultimately result in double inclusion by its United States shareholders. The regulations therefore properly provide that the concept of presumptive dividends is inapplicable to Subpart F.[37]

Section 954 creates several exceptions to the general rule of inclusion with respect to dividends.[38] Because these exceptions apply to interest, and gains from securities transactions, as well as to dividends, discussion of them will be deferred until the inclusionary rules applicable to these other types of income have been examined.

Interest. Interest is defined as amounts, includible in gross income, received from the use of money loaned.[39] Interest is generally includible in FPHCI.[40]

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31. I.R.C. §954(c)(1); TREAS. REG. §1.954-2(a) (1964); I.R.C. §553(a)(1); TREAS. REG. §1.553-1, T.D. 6739, 1964-2 C.B. 156.

32. I.R.C. §§316, 301, 317; TREAS. REG. §1.551-2(e) (1960).

33. TREAS. REG. §1.543-1(b), T.D. 7261, 1973-1 C.B. 309; TREAS. REG. §1.551-2 (1960); TREAS. REG. §1.555-2(a)(ii), (b) Ex. 4 (1960).

34. See note 28 *supra.*

35. TREAS. REG. §1.555-2 (1960); TREAS. REG. §1.555-2(a)(ii), (b) Ex. 4 (1960).

36. I.R.C. §951(a), (b). Avoiding a double tax when these earnings are actually repatriated is accomplished under §959(b). *See* TREAS. REG. §1.959-1, -2.

37. This result is achieved indirectly. The regulations provide: "[N]o amount which would be considered a dividend under §553, solely by reason of the application of §555(b), shall constitute foreign personal holding company income." TREAS. REG. §1.954-2(a) (1964). It is §555(b) which creates the concept of a presumptive dividend. See notes 33-34 *supra.*

38. *See* I.R.C. §954(c)(3)(B), (C), (4)(A).

39. I.R.C. §553(a)(1); TREAS. REG. §1.553-1, T.D. 6739, 1964-2 C.B. 156, adopting the definition in TREAS. REG. §1.543-1, T.D. 7261, 1973-1 C.B. 309, 317.

40. The regulations distinguish for purposes of Subchapter G amounts paid in the nature of interest on debts incurred by purchasing certain realty from a foreign corporation in the ordinary course of business. TREAS. REG. §1.543-1(b)(2) & (10) (1960). Such amounts are sometimes to be considered rent. TREAS. REG. §1.543-1(b)(10) (1960). For Subpart F purposes, all such amounts are, however, to be considered interest. TREAS. REG. §1.553-1(a) (1964); TREAS.

Technically, the time-price differential charged for the privilege of paying for personal property in installments is not an amount paid for the use of money loaned, and is therefore not within the literal definition of interest found in the regulations. Such amounts are conventionally treated as a part of the purchase price of the property, or termed a finance or carrying charge. There is some uncertainty in the III-G regulations as to whether such amounts are FPHCI for section 553 purposes.[41] The section 954 regulations are not dispositive, but they do provide some guidance. An item of income is to be classified according to the substance of the transaction.[42] This means that, in the case of an integrated business engaged in activities and operations conventionally undertaken by separate enterprises, income is flavored by its predominant characteristic.[43] For example, a foreign corporation which engages in the purchase and sale of goods includes amounts attributable to the time-price differential as income derived from the sale of property. However, if the payment obligation is discounted by a finance company, the same payment to the finance company would be characterized as interest. In the first instance, the sales income would not be FPHCI. In the latter case, the interest would be includible.[44]

Interest is defined as an amount of gross income. Generally, in testing to determine whether a foreign corporation has realized income, it is required to put itself in the place of a domestic personal holding company.[45] Because interest paid to a domestic corporation on state obligations is ordinarily excluded from gross income,[46] a CFC will be entitled to the same exclusion.[47]

Treatment by the Regulations of both CFCs and FPHCs "as if" they were domestic corporations raises several questions. For example, there is no doubt that section 482 gives the Commissioner the power to reallocate income between a domestic corporation and a foreign subsidiary for the purpose of recomputing the income of the domestic corporation.[48] Does it follow that Subpart F, read with section 482, gives the Commissioner power to allocate income between two foreign entities for the purpose of increasing the amount of Subpart F Income in order to "fairly reflect income"? Considering the almost insurmountable burden of proof imposed on the taxpayer when the Commissioner

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REG. §1.954-2(a) (1964). This point is of some significance, since the exceptions applicable to interest are different from those which apply to rents. *See, e.g.*, I.R.C. §954(c)(3) & (4).

41. The personal holding company regulations do not speak to the issue at all. *Compare* Southeastern Finance Co., 4 T.C. 1069 (1945), *aff'd*, 153 F.2d 205, 1946-1 U.S. Tax Cas. ¶9157 (5th Cir. 1946), *with* Elk Discount Corp., 4 T.C. 196 (1944). *See also* Rev. Rul. 67-297, 1967-2 C.B. 87; Rev. Rul. 57-541, 1967-2 C.B. 319.

42. *See* TREAS. REG. §1.954-1(f)(1) (1964).

43. TREAS. REG. §1.954-1(f)(2) (1964).

44. *Id.*

45. TREAS. REG. §1.954-2(a) (1964); I.R.C. §§555(a), 553(a); TREAS. REG. §1.555-1 (1960). Section 553 controls for §954(c). Section 553(a) defines FPHCI as "that portion of gross income" which consists of the seven listed items. Gross income is defined for III-G purposes by §555(a) as "gross income computed . . . as if the foreign corporation were a domestic corporation which is a personal holding company." *See* TREAS. REG. §1.555-1 (1960). *See also* TREAS. REG. §1.952-2(a) (1965) which reaffirms this result.

46. I.R.C. §103.

47. Rev. Rul. 72-527, 1972-2 C.B. 456.

48. *See* B. BITTNER & J. EUSTICE, *supra* note 2, at ¶¶17-30.

resorts to his reallocation powers, the problem is a serious one. Assuming that section 482 can be applied as between two foreign entities, it is possible that the Commissioner's attempts to "create income" by imputing uncharged and unpaid interest to a lending corporation could increase the amount of FPHCI which will be attributed to United States shareholders.[49]

Another issue facing a domestic corporation attempting to determine whether it has realized interest income is the problem of thin capitalization.[50] The Commissioner may assert that what a corporation has denominated a debt security is in fact equity. Because both interest and dividends are ordinarily includible in FPHCI subject to the same exceptions, there are probably few instances in the context of Subpart F when such a reclassification would impact substantially on a shareholder's tax liability. However, because the Subpart F regulations provide that the substance of a transaction controls over its form, there is little doubt that the thin capitalization weapon is available to the government. There are at least two situations in which the distinction between interest and dividends could be significant. First, the debt-equity distinction would be important if the government took the position that payments received on a purported debt denominated by a CFC as principal were in fact dividends. There are also limited situations in which a payment to a CFC by a related corporation would qualify for exclusion if the payment were interest but not if it were a dividend.[51]

Annuities. Amounts paid to a CFC under an annuity contract are includible in FPHCI to the same extent they would be includible to a domestic corporation under section 72.[52] To the extent that amounts received under an annuity contract are definitely determinable, the corporation must recognize as income that portion of each payment which exceeds the amount allocated to recovery of capital based on an exclusion ratio.[53] Payments are definitely de-

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49. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at ¶15.06(4). Also uncertain is whether other Code sections that apply special rules to domestic corporations can be applied to CFCs, impacting on their United States shareholders. For example, §483 can permit the Commissioner to convert a portion of what the parties to a transaction have denominated the sale price for goods into interest, hence potential FPHCI. It is possible that the §305 and §306 stock rules could apply, although to the extent that only changes in characterization result, it might be assumed that the impact on a United States shareholder would be minimal. Suppose, however, that a CFC engages in a stock transaction that would produce ordinary income if §305 or §306 applied, but the country in which the transaction occurs has no equivalent rule, so that the income is taxed at a reduced rate. If the CFC's United States shareholders wish to show that there was no substantial reduction of taxes, and hence no tax avoidance purpose under §954(b)(4), is the appropriate point of reference the United States ordinary income or capital gain rate? In addition, these sections can result in increasing the amount of income a shareholder must recognize in what would otherwise be wholly or partly nonrecognition transactions. Must the CFC recognize such income in computing its FPHCI?

50. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at ¶¶4-12 & 13, 4-41, 6-35.

51. See text accompanying notes 177-182 *infra*. *See* Lupowitz Sons, Inc., 497 F.2d 862, *reversing* 31 T.C.M. (C.C.H.) 1169 (1974).

52. TREAS. REG. §1.553-1, T.D. 6739, 1964-2 C.B. 156; TREAS. REG. §1.543-1(b) (4) (1960); PROPOSED TREAS. REG. §1.543-4(d).

53. *See* TREAS. REG. §§1.72-1, T.D. 6676, 1963-2 C.B. 41; -2, T.D. 6885, 1966-2 C.B. 307; -3 (1960); -4, T.D. 7352, 1975-1 C.B. 34.

terminable if either the total amount payable or the payout period is reasonably ascertainable at the time payments begin under the annuity.[54] The exclusion ratio is computed with reference to the cost of the annuity and the total amount which is likely to be paid before the annuity terminates.[55] If the contract is not definitiely determinable either in amount or term, the annuitant is entitled to recover the basis of its contract first,[56] and additional payments are income in their entirety.[57] However, even in circumstances in which capital gains are recognized,[58] the effect to the United States shareholder of a CFC is the same. Amounts of FPHCI are imputed as dividends to United States shareholders.[59] There is no characterization flow-through and consequently any FPHCI not offset by deductions at the CFC level[60] is taxed as ordinary income.

Royalties. The final item includible in FPHCI via section 553(a)(1) is income from royalties. The distinctions between rent and royalties are of considerable significance for Parts II and III of Subchapter G.[61] However, the significance of the distinctions is virtually eliminated in Subpart F.[62] Both rents and royalties are ordinarily fully includible, subject to section 954(c) exceptions which apply to each in similar fashion.[63] Detailed consideration of royalties will therefore be deferred and discussed in connection with rents.[64]

Section 553(a)(2): Net Gains from Sales of Stock and Securities

The second major class of passive income subject to inclusion in FPHCI is the excess of gains over losses from sales and exchanges of stock or securities.[65] It has already been noted that such transactions can easily be structured to completely avoid international taxation where the country of incorporation elects not to impose a residual income tax.[66] Because such transactions are not

54. TREAS. REG. §1.72-2(b) (1960).

55. *See* TREAS. REG. §1.72-4(a)(1)(i), T.D. 7043, 1970-2 C.B. 22; TREAS. REGS. §§1.72-5, (1960); -6, T.D. 7311, 1974-1 C.B. 234.

56. TREAS. REG. §§1.72-1, T.D. 6676, 1963-2 C.B. 41; -11(c), T.D. 6885, 1962-2 C.B. 307.

57. TREAS. REG. §1.72-1(a) (1960), -11, T.D. 6885, 1962-2 C.B. 307.

58. *See* TREAS. REG. §1.72-1, T.D. 6676, 1963-2 C.B. 41; I.R.C. §61.

59. Proceeds received on sale would not be payments under the contract. *See* TREAS. REG. §1.72-10 (1960) for effect of sale on basis to purchaser.

60. See text accompanying notes 194-96 *infra.*

61. Royalties are generally fully includible. I.R.C. §553(a)(1). Rents are excludible if they exceed 50% of gross income. I.R.C. §553(a)(7). *See also* I.R.C. §§543(a)(1)-(5); TREAS. REG. §1.543-1(b)(3), T.D. 7261, 1973-1 C.B. 309.

62. *See* I.R.C. §954(c)(2); TREAS. REG. §1.954-2(a), (b) (1964).

63. I.R.C. §954(c)(3)(A), (c)(4)(C).

64. See text accompanying notes 98-103 *infra.*

65. The regulations define "stock or securities" very broadly. The term includes any interest in a corporation or organization classified as a corporation under the Code in the nature of "stock, stock rights or warrants, . . . certificates of interest or participation in any profit-sharing agreement, or in any oil, gas, or other mineral property, or lease, . . . voting trust, certificates, bonds, debentures, certificates of indebtedness, . . . bills of exchange, [or] obligations" issued by a governmental entity. TREAS. REG. §1.543-1(b)(5) (1960). However, it has been held that a grant providing for the conveyance of an undivided inteerst in the mineral content of specific land which conveyed an interest in the land itself rather than a royalty interest, was not a security. Plow Realty Co. of Texas, 4 T.C. 600 (1944), *acquiesced in,* 1945 C.B. 6.

66. See text accompanying note 13 *supra.*

ordinarily part of an active trade or business, there is no reason why shareholders in the United States should be permitted to use a corporate shell to defer United States tax on this income.

Applying the rule of inclusion requires only three steps. First, interests sold or exchanged must be identified as stock or securities. Second, various exceptions must be considered and transactions falling within them excluded. Finally, includible transactions must be netted out to produce a gain or loss. A net gain is included in FPHCI. Net losses are disregarded. There can be no loss carryovers.[67]

The term "sale or exchange" has the same meaning here as in Chapter 1 of the Code.[68] All gains and losses that would be recognized and included in gross income under Chapter 1 are includible as FPHCI.[69] This includes gain on liquidating dividends and other distributions from capital to the extent they would be includible in the gross income of a domestic corporation.[70] Nonrecognition elections available to domestic corporations should be available to CFCs, and the Service has indicated that this is the rule.[71] Although the net gain includible will always be a capital gain, there is no deduction for a domestic corporation equivalent to the section 1202 deduction available to individuals. Thus, a CFC is entitled to none. To the extent that FPHCI carries through to U.S. shareholders, the net gain is taxed in full as ordinary income.[72]

An important exception contained in section 553(a)(2) excludes from FPHCI net gains realized by dealers[73] in stock or securities to the extent derived in the ordinary course of business. Because dealers are engaged in an active business, the III-G policy directed against purely passive income is inapplicable. Although it may still be possible for a dealer-CFC to structure transactions so as to limit international tax, Subpart F does not expand the scope of FPHCI in order to include such transactions. Corporations, however,

67. TREAS. REG. §1.453-2 (1960); TREAS. REG. §1.952-2(c)(5) (1965).

68. *See* TREAS. REG. §1.952-2(c)(3) (1965); TREAS. REG. §1.543-1(b)(5) (1960); TREAS. REG. §1.543-2 (1960). *See also* I.R.C. §1001; TREAS. REG. §1.1002-1 (1958). (Note: I.R.C. §1002 was repealed, Pub. L. 94-455, tit. XIX, §1901(b)(28)(B)(i), 90 Stat. 1799.)

69. *Id. See also* TREAS. REG. §1.952-2(a), (c)(3) (1965).

70. *See* Construction Aggregates Corp. v. United States, 350 F. Supp. 726 (N.D. Ill. 1972), *aff'd mem.*, 483 F.2d 1406 (7th Cir. 1973).

71. *See* Rev. Rul. 73-277, 1973-1 C.B. 296. However, it is imperative that special notice requirements imposed on foreign corporations be observed and advance rulings obtained where necessary. *See* Construction Aggregates Corp. v. United States, 350 F. Supp. 726 (N.D. Ill. 1972), *aff'd mem.*, 483 F.2d 1406 (7th Cir. 1973).

72. *See* I.R.C. §951; TREAS. REG. §1.951-1(a) (1965). *But see* TREAS. REG. §1.951-1(a)(2) (1965) for a special rule affecting certain computations relating to domestic personal holding companies. Although §951, unlike §551, does not use the word dividend, it is clear this is the effect.

73. A regular dealer in stock or securities is a corporation with an established place of business regularly engaged in the purchase of stock or securities for resale to customers. TREAS. REG. §1.543-1(b)(5)(ii) (1958). The exception extends only to transactions in the normal course of business. The fact that a foreign corporation acquires stock with the intention of reselling it to the public at a gain does not necessarily mean that such corporation will be considered a dealer. A dealer engages in such transactions on a regular basis as a trade or business. Occasional involvement in such activities marks a corporation as an investor rather than a dealer, and not within the exception. United States v. Ross, 368 F.2d 455 (2d Cir. 1966).

will not be deemed dealers with respect to stock or securities held for investment (within the meaning of section 1236) rather than primarily for sale to customers.[74]

Several other exceptions to the rule of inclusion will be discussed below in conjunction with exceptions for interest and dividends. Although the statute speaks only in terms of gains, loss transactions must be netted against gains.[75] A corollary is that transactions that would be within an exception if gain had been produced do not create losses that can be netted against includible gains. If a transaction is for any reason within an exception, neither the gain nor loss produced may be used in deriving the net gain includible in FPHCI.

Section 553(a)(3): Commodities Futures

FPHCI generally includes the excess of gains over losses from commodities futures transactions.[76] The only exception to this rule permits the exclusion of certain hedging transactions by merchants and producers who use the commodity in a trade or business. Futures transactions are within the ambit of section 553 when they involve a commodity or product which is traded on or subject to the rules of a board of trade or commodity exchange.[77]

CFCs which buy futures without any prospect or intention of taking delivery are speculating that between the date of purchase and the date the property is to be made available, the market price of the property will rise. If it does, the holder will sell the future and reap a gain, somewhat akin to trading in stock options. Similar to transactions involving gains from sales of stock and securities, a CFC must ordinarily net gains on commodities sales against losses and include any net gain in FPHCI. A net loss may not be carried to another year or used to offset another type of FPHCI.[78]

Unlike transactions involving stock and securities, however, there is no dealer exemption. The single exception to the general rule of inclusion reaches a CFC which engages in hedging as part of its ordinary trade or business. Some corporations purchase futures in order to assure a continuous supply of the materials used in their businesses. These purchases are not speculative in that there is a reasonable probability that if the market price of the commodity does not change or rises above the price set by the contract, the holder will actually take delivery of the commodity. Futures held by such corporations are not

74. TREAS. REG. §1.543-1(b)(5)(ii) (1958).

75. TREAS. REG. §1.543-1(b)(5)(i) (1958). *See* TREAS. REG. §1.952-2(c)(2)(b)(v) (1965). Earlier the Treasury took the position that the statute contemplated that gains should be included in FPHCI without regard to losses. The courts uniformly rejected this argument and the statute has since been amended to adopt more clearly the judicial view. *See* Sicanoff Vegetable Oil Corp. v. Commissioner, 251 F.2d 764 (7th Cir. 1958) (commodities transactions).

76. Commodity futures are rights to purchase and sell at an agreed upon price property (a commodity) not yet identified. They are intangibles conceptually similar to other intangibles such as securities and commercial paper. Trading in commodities futures is not an active trade or business within the meaning of the Code and therefore produces passive income within the policy reach of §553. Gain realized from such trading is ordinarily capital.

77. I.R.C. §553(a)(3); TREAS. REG. §1.543-1(b)(6) (1958). *See* I.R.C. §1233. *See* Sicanoff Vegetable Oil Corp. v. Commissioner, 251 F.2d 764 (7th Cir. 1958).

78. PROPOSED TREAS. REG. §1.553-2(a) (1968); TREAS. REG. §1.952-2(c)(2)(v), (3) (1965).

capital assets but rather a form of stock in trade.[79] Thus, the exception excludes gains realized on the sales of such futures to the extent the CFC is a "producer, processor, merchant, or handler of the commodity,"[80] but only if the transactions in which the futures are bought and sold "arise out of bona fide hedging transactions reasonably necessary to the conduct of its business in the manner in which such business is customarily and usually conducted by others."[81]

Section 553(a)(4): Estates and Trusts

The amount of inclusion under this paragraph is determined by assuming that the CFC is a domestic corporation which is a beneficiary of a trust as defined by section 643(c).[82] If the trust that distributes income to the CFC is a foreign trust, a number of special rules within Subchapter J apply. Some affect the computation of Distributable Net Income (DNI)[83]; others directly affect the tax liability of the beneficiary.[84]

The conduit approach to distributions adopted by the Code means that the quality of items making up DNI is retained upon distribution.[85] Thus, amounts in excess of qualitative DNI which are not subject to throwback rules are not gross income, and amounts deemed to constitute tax exempt interest retain their character in the hands of a beneficiary. Conversely, section 553(a)(4) requires that all income which would be includible in the income of a domestic corporation be included in FPHCI. There is therefore an issue as to whether exemptions for certain kinds of income permitted by section 954(c) should take priority to exempt items which are qualitatively interest, dividends, sales of securities, or rents and royalties, which would, if paid directly to the CFC, be excludible items. The regulations do not speak to this issue. However, the better view is that the flow-through nature of trust distributions should make the section 954 exceptions available. This is because the policy governing the taxation of trusts renders the trust a non-entity for the purpose of characterizing distributions in the hands of beneficiaries. What is rent to a trust should continue to be rent when paid to the beneficiary CFC.

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79. Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955). A CFC which purchases futures as a hedge against the possibility the market price of the commodity will rise before the corporation has actual need of the commodity may sell the future when the CFC discovers it has no need for the commodity, without fear of generating FPHCI. Since the CFC is engaged in an active trade or business, the futures constitute a business asset and the income produced by their sale is not passive. It would, therefore, be improper to include such amounts in FPHCI. A CFC which deals in a commodity may nevertheless realize includible FPHCI if its futures transactions are more extensive than is justifiable considering the CFC's business needs as a whole. PROPOSED TREAS. REG. §1.553-2(a); TREAS. REG. §1.952-2(c)(2)(v), (3) (1965).

80. TREAS. REG. §1.543-1(b)(6) (1958).

81. *Id. See* I.R.C. §1233; TREAS. REG. §1.1233-1, T.D. 6926, 1967-2 C.B. 289.

82. A corporation may be a beneficiary. *See* I.R.C. §643(b).

83. *See, e.g.*, I.R.C. §643(a)(6).

84. *See, e.g.*, I.R.C. §668. The Tax Reform Act of 1976 made several changes in the treatment of foreign trusts. *See* S. REP. No. 94-938, 94th Cong., 2d Sess. (1976), 1976-3 C.B. 49.

85. *See* SURREY, WARREN, MCDANIEL & AULT, 1 FEDERAL INCOME TAXATION: CASES AND MATERALS, 1304-42 (1972).

Amounts received by a beneficiary which pull DNI out of a trust are ordinarily items of income without any offsetting deductions. Most allowable deductions have already been netted out prior to the DNI computation in section 643(a). There are, of course, exceptions involving depreciation,[86] but ordinarily there will be no deductions to take into account under section 954(b)(5). This has the potential to affect computations under the section 954(b)(3) 10-70 percent test.[87]

Section 553(a)(5): Personal Service Contracts — Incorporated Talent

The sixth item includible in FPHCI is income derived from contracts under which a CFC undertakes to furnish certain personal services and amounts received on the sale of such contracts. The provision primarily seeks to eliminate potential abuse of the corporate form by a movie star or other person with a unique talent who incorporates himself. The corporation would "employ" the star and pay a modest salary while hiring the star out at fair market value. The excess of the amount received over the amount paid as salary could escape tax entirely. While the intent of Congress was to correct a specific abuse, the reach of this section has been expanded because of the courts' tendency to apply its terms literally without imposing a requirement that the person whose services are contracted for be in any sense a unique commodity.[88]

Section 553(a)(6): Use of Corporate Property by Shareholders

The sixth paragraph of section 553 applies to amounts received from certain shareholders of foreign corporations paid for the use of or right to use corporate

86. *See* I.R.C. §§642(e) & (f), 167(h), 169(i).

87. Section 954(b)(3) creates a rule of convenience. If less than 10% of a CFC's gross income consists of foreign base company income, foreign base company income is treated as being zero. However, if more than 70% of the gross income of the CFC is foreign base company income, its entire gross income is included in foreign base company income. This test is conducted with reference to gross income; thus, before deductions. I.R.C. §954(b)(3).

88. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at ¶¶239, 250-1. *See* S. O. Claggett, 44 T.C. 503 (1965), *acq.*, 1966-2 C.B. 4. I.R.C. §553(a)(5); TREAS. REG. §1.543-1(b)(8), T.D. 6739, 1964-2 C.B. 156. *See* Kurt Frings Agency, Inc., 42 T.C. 472, *aff'd per curiam*, 351 F.2d 951 (9th Cir. 1965).

The applicability of this section is narrowly confined; both the following requirements must be satisfied:

(1) Either the name of the person who is to perform the services must be designated in the contract, or some person other than the corporation must have the right to designate the individual who is to perform the services;

(2) At some time during the tax year of the CFC, 25% of the value of its outstanding stock must be owned by or for an individual who has performed, is to perform, or may be designated as the one to perform such services. Stock ownership is reckoned under §§542 and 544. In the event the basic requirements of the paragraph are met, but the contract calls for the performance of ancillary services by others who are not 25% shareholders, there is to be a reasonable allocation with only amounts attributable to the 25% shareholder(s) included in FPHCI. *See* General Management Corp., 135 F.2d 882 (7th Cir.), *cert. denied*, 320 U.S. 757 (1943). There are numerous revenue rulings relating to personal service contracts. *See, e.g.*, Rev. Rul. 54-34, 1954-1 C.B. 1975; Rev. Rul. 75-67, 1975-1 C.B. 169; Rev. Rul. 75-249, 1975-1 C.B. 171; Rev. Rul. 75-250, 1975-1 C.B. 172.

property.[89] The paragraph is designed to make avoidance through indirect dealing or indirect stock ownership difficult, but its scope is subject to limitations that reduce its effectiveness.[90]

Only corporations which engage in sheltering activities as a substantial part of their aggregate activities are subject to the operative rules of section 553(a)(6). They are not intended to reach corporations which are actively engaged in rental businesses and receive only a small part of their revenues from passive sources. Therefore, if 10 percent or less of the gross income of the corporation is FPHCI, computed without regard to amounts includible only as rental income or income under this paragraph, there is no inclusion under this paragraph at all.[91]

The application of this provision in the context of Subpart F is presumably rather limited, because the composition of the United States control group must not make the CFC a foreign personal holding company. However, the exceptions under section 954(c) excluding certain rents and royalties received in the active conduct of a trade or business or from a related person should be available to a non-holding company CFC which does realize such disfavored income.[92]

Section 553(a)(1) and (7): Royalties and Rents

Although the policy of section 553 is to tax foreign corporations whose income consists of at least 60 percent FPHCI,[93] Congress also determined that in spite of the generally passive nature of rental income, a foreign corporation that earned more than half of its gross income from rentals was likely to be engaged in the active conduct of a rental business. Section 553 therefore exempts from

89. This provision was originally directed at attempts by high income taxpayers to incorporate yachts, residences or other property used by such individuals for the purpose of converting them into business asssets. The shareholder's hope was that rentals paid would be less than depreciation allowable to the corporation, and that the loss incurred on such property could be carried over to reduce other corporate income. *See* B. BITTKER & J. EUSTICE, *supra* note 2, at 239, 248-50. The provision also limits the ability of a taxpayer to acquire such property with income that would, at least partially, never be taxed at §1 rates. If a foreign corporation were to purchase the asset under a time payment plan with members of the corporate control group securing the payment obligation, the corporation could pay off the debt, at least in part, with rental income taxed, if at all, only to the corporation. *Id.*

90. As with personal service contracts, includible transactions are limited to those in which the shareholder who enjoys the right of use owns 25% or more in value of all outstanding stock of the CFC at some time during the tax year. *See* PROPOSED TREAS. REG. §1.543-9(a) (1968).

91. I.R.C. §553(a)(6); PROPOSED TREAS. REG. §1.543-9(b) (1968). The test should not be confused with the 10-70 test of §954(b)(3). See note 87 *supra*. The 10-70 test is in the nature of a de minimis limitation which can be applied only after all amounts includible under §954(c) through (f) have been determined. The 10% test in §553(6) applies: (1) only when there is income otherwise within §553(6), and (2) only when elements of FPHCI includible under §553(1) through (5) (without regard to limitations imposed by §954(c)) exceed 10% of gross income.

92. *See* 954(c)(4)(C). See text accompanying notes 194-96 *infra*. *But see* text accompanying note 98 *infra*.

93. I.R.C. §§552, 551, 556.

FPHCI the entire rental income of a foreign corporation if rental income constitutes 50 percent or more of its gross income.[94]

Section 954(c) treats items of FPHCI more selectively. Rents are included in FPHCI without regard to whether such rents constitute 50 percent or more of gross income[95]; however, rent derived in the active conduct of a trade or business is specifically excluded.[96] Because this rule of exclusion is also applicable to royalties, rents and royalties are considered together under this subpart. The general rule for section 954 is that both are fully includible in FPHCI subject to two exceptions.[97] Rent, unless the context requires otherwise, includes compensation paid for the use and possession of real or personal property.[98] The rental of apartments and office buildings as well as equipment falls within this definition.[99] Leases of motion picture films, whether the film is created, purchased, or leased by a CFC, generates rental income.[100]

Amounts received under a copyright license, on the other hand, are classified as royalty income.[101] The term royalty ordinarily includes amounts of gross income received for the privilege of using patents, secret processes and formulas, good will, trademarks, trade brands, franchises, and other like property.[102] Because royalties are paid for the use of intangible personal property, there is an overlap between the regulations' definition of rent and the ordinary meaning of term royalty, which appears in the statute.[103] Because the inclusionary rules are coextensive, however, there is probably little significance to this conflict.

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94. I.R.C. §552(a).

95. I.R.C. §954(c)(2); TREAS. REG. §1.954-2(b) (1964).

96. I.R.C. §954(c)(3)(A); TREAS. REG. 1.954-2(d)(1)(ii) (1964). See text accompanying notes 121-134 *infra*.

97. TREAS. REG. §1.954-2(b) (1964); TREAS. REG. §1.553-1(b), T.D. 6739, 1964-2 C.B. 156; TREAS. REG. §1.543-1(b)(10) (1956). The exceptions are I.R.C. §954(c)(3)(A) and (4)(C).

98. TREAS. REG. §1.954-2(a) (1964). Section 553 contains an unusual wrinkle which excludes from the definition of rents amounts paid for use of corporate property by a shareholder who owns 25% or more of the value of the CFC's outstanding stock. This exception is significant for §553 because such amounts are not included to bring the total of aggregate rentals over the 50% threshold. The exclusion also prevents a double inclusion as a result of §553(a)(6). See text accompanying note 89 *supra*. Section 954(c) abrogates the 50% rule but makes no statutory change in the definition of rents. The definition of rents under the regulations should be read to end the distinction drawn between §553(a)(6) and §553(a)(7). Certainly the reason such a distinction was originally created has no relevance to §954. However, it can also be argued that §553(a)(7) explicitly states that these special transactions are not "rents" within that paragraph. The term "rents" is not used in §553(a)(6), which picks up such amounts for purposes of III-G. Therefore, if amounts are includible under §553(a)(6), they are not §553(a)(7) rents, and the §954 exceptions applicable to rents cannot apply to them. A regulation purporting to change this result would arguably exceed the authority delegated to the Treasury. *See* I.R.C. §954(c); §553(a)(6), (7).

99. TREAS. REG. §1.954-2(d)(1)(ii)(c), Ex. (1), (4)-(6), T.D. 6784, 1965-1 C.B. 344.

100. TREAS. REG. §1.954-2(d)(1)(ii)(c), Ex. (2) & (7), T.D. 6784, 1965-1 C.B. 344.

101. TREAS. REG. §1.954-2(d)(1)(iii)(c), Ex. (1)-(5), T.D. 6739, 1964-2 C.B. 156.

102. TREAS. REG. §1.543-1(b)(3), T.D. 6739, 1964-2 C.B. 156.

103. Two types of royalties which are not within the regulation's definition of rent are copyright royalties and royalties paid by extractive industries. The term copyright royalty means compensation, however designated, for the use of or right to use copyrights in works protected by any international convention to which the United States is a signatory. TREAS. REG. §1.543-1(b)(12)(iv), T.D. 6739, 1964-2 C.B. 156. Mineral, oil, and gas royalties include

SECTION 954(c) EXCEPTIONS TO THE RULE OF INCLUSION

Exceptions for Dividends, Interest and Net Gains from the Sale of Stock or Securities

Section 954(c) contains several exceptions which relate exclusively to interest, dividends, and net gains from the sales of stock and securities. The regulations interpreting these exceptions are dense and rather complicated. In general, there are two categories of exceptions; those which relate to certain special enterprises receiving dividends, interest, and securities gains, and those applicable to transactions between a CFC and a "related person."[104] Unifying the various components of FPHCI is the policy that the corporate form should not be a significant barrier to current taxation when the primary assets of a corporation produce passive income. Congress, however, has identified two forms of enterprise, insurance and banking, which do conduct active businesses but because of the nature of their enterprises attract large amounts of income, usually thought of as "passive".[105]

Section 954(c)(3)(B) provides an exemption from FPHCI for interest, dividends, and securities gains "derived in the conduct of a banking, financing, or similar business . . . which are received from a person other than a related person."[106] The related person limitation is included because Congress elected to deal with the problem of transactions between related corporations with a separate set of exceptions to be discussed later.

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mineral production payments which would not be deemed loans under §636, and any other amounts received from an interest in mineral, oil, or gas properties. TREAS. REG. §1.543-1(b)(11)(ii), T.D. 7261, 1973-1 C.B. 309; TREAS. REG. §1.553-1(b), T.D. 6739, 1964-2 C.B. 156. Minerals include all ores and metallic and nonmetallic deposits in place, excluding minerals derived from seawater and other inexhaustible sources. TREAS. REG. §1.611-1(d)(5) (1960). Overriding royalties include amounts received from a sublessee by an operating company that originally leased and developed the natural resource property in respect of which the royalties are paid. TREAS. REG. §1.543-1(b)(11)(ii) & (iii), T.D. 7261, 1973-1 C.B. 309; TREAS. REG. §1.553-1(b), T.D. 6739, 1964-2 C.B. 156.

104. See text accompanying notes 145-146 *infra*. For a discussion of the related person exception which applies specifically to interest and dividends (but not gains from the sale of stock or commodities futures), see text accompanying note 148 *infra*.

"Related person" is a term of art significant for all elements of foreign base company income, and is defined by I.R.C. §954(d)(3) and its accompanying regulations.

105. *See* S. REP. No. 1881, *supra* note 14, at 3385-86. All the exceptions contained in §954(c) are rationalized as an attempt to maintain "active American business operations abroad on an equal competitive footing with other operating businesses in the same countries." Many economists question the argument that the income tax is a cost of doing business. The better view is that the income tax is a charge on profits and therefore falls upon capital rather than operations. In any event, banking and insurance are both so heavily regulated that it is questionable that competition exists in either industry. *See* L. Lokken, *supra* note 2, 127-29.

The policy underlying the exceptions for banking and insurance enterprises roughly parallels that for exempting securities dealers from the rule of inclusion pertaining to securities transactions. A CFC engaged in banking or insurance is not using the corporate form primarily as a tax shelter for its shareholders. It is instead engaging in an active business which is likely to attract some tax at the situs of its operations. Congress concluded that finance, banking, and insurance enterprises were sufficiently distinct from holding company flavored corporate shells to warrant separate status.

106. I.R.C. §954(c)(3)(B).

A CFC will be considered to be engaged in the conduct of a banking, financing, or similar business if it engages in a business in the United States or elsewhere consisting of one or more of the activities enumerated in the regulations.[107] These activities include receiving deposits of money, making loans, providing trust services, underwriting securities offerings, and dealing in commercial paper and foreign currencies. One requirement imposed with respect to all these activities is that they be carried on with the general public.[108] A CFC which acts as a mere financing vehicle, borrowing funds on behalf of a parent corporation or other related person, will not qualify.[109]

The fact that a CFC is subject to the banking laws of the United States or a foreign country does not in itself assure that the exception applies. The CFC must actually transact qualified business in order to take advantage of the exclusion.[110] A CFC that engages in business other than banking (or insurance) may only exclude income from its qualified activities. The regulations apparently contemplate that a CFC engaging in multiple businesses will keep books that segregate qualified from non-qualified income. Because banking and insurance enterprises are commonly heavily regulated by the countries in which they operate, this should present no great difficulty.

A special "incidental income" rule permits a CFC that acquires securities as an ordinary and necessary incident to the conduct of a banking business (e.g., through foreclosure) to hold such securities for a reasonable period awaiting an advantageous time for sale. Interest and dividends attributable to such securities are excludable, as is any gain realized upon their eventual sale. However, a CFC is not entitled to exclude such income under this rule indefinitely.[111]

A special variant of the section 954(c) exception is available for CFCs which are subsidiaries of members or affiliates of the Federal Reserve System. Subsidiaries of these "Edge Act or Agreement Corporations" are considered to engage in banking activities without regard to whether they deal with the public. They are also exempt from the incidental income limitation discussed above.[112]

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107. TREAS. REG. §1.954-2(d)(2)(ii), T.D. 7497, 1977-33 I.R.B. 18.
108. TREAS. REG. §1.954-2(d)(2)(ii)(a)-(d), T.D. 7497, 1977-33 I.R.B. 18.
109. TREAS. REG. §1.954-2(d)(2)(ii), T.D. 7497, 1977-33 I.R.B. 18.
110. TREAS. REG. §1.954-2(d)(2), T.D. 7497, 1977-33 I.R.B. 18.
111. TREAS. REG. §1.954-2(d)(2)(iii), T.D. 7497, 1977-33 I.R.B. 18.
112. TREAS. REG. §1.954-2(d)(2)(iv) (1964).

To fall within the Edge Act exception a CFC must satisfy several additional requirements. First, more than 50% of the combined voting power of all the stock of the CFC must be owned or considered as owned (under §958) by a domestic corporation organized under the Federal Reserve Board under §25 of the Act. Second, all stock of a domestic parent which is not itself a member of the Federal Reserve System must be owned by national or state banks which are members of the Federal Reserve System. Third, not more than 20% of the gross income of the CFC may consist of the aggregate of the following amounts:

(1) FPHCI, excluding interest, dividends, and net gains from the sale of stock and securities;
(2) foreign base company sales income, determined under TREAS. REG. §1.954-3, T.D. 7555, 1978-37 I.R.B. 9;
(3) foreign base company services income, determined under TREAS. REG. §1.954-4, T.D. 6981, 1968-2 C.B. 314.

Section 954(c) also contains two exceptions involving insurance companies.[113] The first excepts from inclusion in FPHCI interest, dividends, and net gain from stock and securities transactions "derived from the investments made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business." As with banks, income received from a related person is not within the exception,[114] but there is another exception which could apply under certain circumstances to such income.[115] The two terms of greatest importance to the exception from FPHCI for income from investments by an insurance company are unearned premiums and ordinary and necessary reserves. Unearned premiums are amounts which will cover the cost of carrying an insurance risk for the period for which the premium has been paid in advance.[116] A reserve is a fund maintained by an insurance company to cover the risks of unanticipated claims, failure of investments to perform as anticipated, and to offset the cost of adverse selection.[117] An ordinary and necessary reserve is the highest reserve a CFC is obligated to maintain under any law under which it transacts insurance business, but not in excess of the actual reserve carried.[118]

Reserves and unearned premiums are particularly important in the context of life insurance, where mortality rates increasing with age and the process of adverse selection necessitate the accumulation by the insurer of amounts which substantially exceed the cost of current insurance during the early years of a policy. To establish premiums, the insurer must take into account the expected yield of investments acquired with unearned premiums, such sums reducing the aggregate premium for underwriting the risk over time. A similar approach applies to the cost of annuities. Investment income is thus an integral part of the insurance business. Congress determined that such passive income served a much different function in the insurance industry than to the investment portfolio shelters of other CFCs, and warranted separate status.[119]

113. Insurance is not defined by the regulations but is probably to be given its conventional meaning, an undertaking whereby an underwriter agrees to indemnify the insured for losses incurred from stated risks. The cost of this undertaking to the insured is a premium determined under rated actuarial projections. *See* BLACK'S LAW DICTIONARY, "Insurance," 943 (revised 4th ed. 1968). As with the banking exception, the actual character of the business transacted by a CFC rather than the fact that the CFC is subject to the insurance laws of a foreign country determines the applicability of this exception. TREAS. REG. 1.954-2(d)(3)(i), T.D. 6781, 1965-1 C.B. 320.

114. I.R.C. §954(c)(3)(B). *See* TREAS. REG. §1.954-2(d)(3), T.D. 6781, 1965-1 C.B. 320.

115. I.R.C. §954(c)(4)(A). See text accompanying note 183 *infra*.

116. TREAS. REG. §1.954-2(d)(3)(i), T.D. 6781, 1965-1 C.B. 320.

117. *See* BLACK'S LAW DICTIONARY, Insurance "reserves," 1473 (Revised 4th ed. 1968); D. BICKLEHAUPT & J. MAGEE, GENERAL INSURANCE 632-36 (8th ed. 1970).

118. TREAS. REG. §1.954-2(d)(3)(ii), T.D. 6781, 1965-1 C.B. 320. The regulations provide that if the reserve required under local law is unreasonably low, a CFC is entitled to claim a reserve which the district director approves as reasonable. *Id.* This particular provision is interesting in light of the second insurance exception, applicable primarily to casualty insurers. See note 119 *infra*.

119. *See* S. REP. No. 1881, *supra* note 14, at 3386. Because casualty insurers do not ordinarily face the problem of adverse selection or risks that increase with the age of a policy, casualty insurers do not need to accumulate reserves to the extent necessary with respect to life insurance. However, since the actuarial projections of casualty insurers tend to be less

Because there is no responsive provision in the regulations, it is unclear how a CFC that maintains an excess reserve under either of the insurance exceptions is to identify investments generating excludable interest, dividends, or gains. In the absence of regulations requiring earmarking, the insurer arguably should be permitted to select investments with the highest yield and treat these as its ordinary and necessary reserve, including only income from the excess as FPHCI. However, the Service would be likely to require the CFC to treat all investments as a common fund, excluding a portion of the income generated by the fund based on the ratio between the fair market value of the ordinary and necessary reserve and the fair market value of the entire fund.

Also unclear is whether the two exceptions may properly be aggregated. Read literally, the statute appears to permit an insurance company to exclude income from investments in an amount equal to its ordinary and necessary reserves *plus* an amount equal to one-third its qualified annual earned premiums. The committee report accompanying the Tax Reform Act of 1976, which added the latter provision, rationalizes the exception as an attempt to clarify the matter of a proper casualty reserve. However, the report also clearly recognized that a new exception was being created.[120] The better view is, therefore, that aggregation is proper.

Exceptions Applicable to Rents and Royalties Received in the Active Conduct of a Trade or Business

Once items of rents and royalties have been identified as gross income, they are includible in FPHCI unless one of the two exceptions in section 954(c) applies. The first pertains to related persons and is discussed in the next part. The second modification excludes rents and royalties derived in the active con-

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stable than those in the life area, casualty insurers are required by some countries to maintain a substantial reserve to protect against unanticipated liabilities. The amount of such reserves required by local law, however, tends to vary widely from country to country. Generally, a casualty insurer is required to include the anticipated return on current premiums when establishing premium rates. However, the insurer is not always required to factor in the investment return on its legal reserve. When the insurer is required to factor the return on reserves into its rate structure, it is clear that such reserve is a business asset.

Despite the fact that the Teasury had indicated a willingness to show flexibility in setting a ceiling on ordinary and necessary reserves (See note 118 *supra*), Congress decided to add an exception which would provide the Treasury with a guideline on the matter of allowable reserves in the area of casualty insurance. *See* S. REP. No. 94-938, *supra* note 84, at 3649-60.

Because of the variability in the legal reserve requirements from country to country, Congress adopted the thumb rule of the National Association of Insurance Commissioners, which recommends a ratio between surplus and earned premiums of 1 to 3, as an amount which would be considered the ordinary and necessary reserve of a casualty insurance company. *Id.* This determination means that a reserve to that extent will be considered a business asset. A CFC may therefore exclude eligible income generated by a fund equal to one-third of the premiums earned by the CFC annually. However, the CFC may not take into account premiums earned on related persons. Finally, premiums attributable, either directly or indirectly, to the insurance or reinsurance of risks of related persons may not be taken into account. I.R.C. §954(c)(3)(C).

120. S. REP. No. 94-938, *supra* note 84, at 3660.

duct of a trade or business, unless received from a related person.[121] The exception provided by this subsection is split by the regulations into two parallel provisions, one for rentals and one for royalties. Both contain qualifying tests which are considerably complex considering the simple language of the Code. In both instances the overriding determination is an inquiry into facts and circumstances, within which safe harbors are created.[122] The frequency of transactions producing rent or royalty income is relevant, but frequency alone is never conclusive in establishing the existence of a rental or royalty business.[123]

The regulations list four instances in which a CFC will be considered engaged in the active conduct of a rental business.[124]

1. An active business exists when leased property has been manufactured or produced by the CFC, or when the CFC has acquired the property by purchase and added substantial value to it.[125] This exception also requires that the CFC regularly be engaged in such activities, and that the income-producing transaction be with an unrelated person. Additions in value produced by the marketing activities of a CFC are not taken into account. The regulation does not define manufacture, production, or substantial additions in value,[126] but does provide several examples. A CFC which manufactures business machines and leases them does not receive includible rental income from such leases.[127] A CFC organized to produce and lease films does not receive includible rental income from leases of films it produces, even though there may be considerable intervals between distributions of finished film products. The Service will consider an organization to be regularly engaged in the production of films as long as there are recognizable benchmarks in the planning and production process at intervals along the way to the completed product.[128]

2. FPHCI of a CFC does not include rentals received from real property,

121. I.R.C. §954(c)(3)(A).

122. *See* TREAS. REG. §1.954-2(d)(1), T.D. 6784, 1965-1 C.B. 344. A safe harbor (or safe haven) is a term in the practitioner's jargon referring to a zone of conduct established by governmental regulations in which an individual may operate without worrying that a rule is being violated. Once the safe harbor is exceeded, the governmental agency which has established the threshold is free to challenge the individual's conduct as violative of the applicable rule or law.

123. TREAS. REG. §1.954-2(d)(1)(i) (1964).

124. As elsewhere in the Code, the definition of a trade or business is conspicuous in its absence.

125. TREAS. REG. §1.954-2(d)(1)(ii)(a)(1), T.D. 6784, 1965-1 C.B. 344.

126. It is possible that the regulations dealing with foreign base company sales income are of some relevance in determining what is meant by production, manufacture, and additions in value. TREAS. REG. §1.954-3(a)(4) (1964) provides guidelines for determining whether goods have been manufactured, produced, or have undergone substantial transformation. The focus in the sales income context is on whether the economic activity involved will attract tax at the situs. The FPHCI focus is on whether the income is "passive." What would be sufficient for purposes of §954(d) may be sufficient for §954(c) as well. However, the converse need not be true. The §954(d) regulations indicate that assembling components into a finished product does not amount to substantial *transformation*. This may mean that the same activities would not be taken into account as a substantial *increase in value*, but such a result is questionable. *See* Dave Fischbein Mfg. Co., 59 T.C. 338 (1972).

127. TREAS. REG. §1.954-2(d)(1)(ii)(c), Ex. (1), T.D. 6784, 1965-1 C.B. 344.

128. TREAS. REG. §1.954-2(d)(1)(ii)(c), Ex. (7), T.D. 6784, 1965-1 C.B. 344.

when the lessor-CFC performs active and substantial management and operational functions while the property is leased. A CFC that leases office space in a large office building that it owns, acts as its own rental agent for the leasing of such offices, and employs a substantial staff to perform management and maintenance functions, may exclude the rental income received from such leases. However, if the same CFC engaged a real estate management firm to perform these functions, its rental income would not be excludible.[129]

3. A CFC engaged in the active conduct of a trade or business other than leasing property may lease, for a temporary period during which the property would otherwise lie idle, equipment or other property which it ordinarily uses in its trade or business. Thus, a CFC engaged in the business of drilling wells may lease its drilling equipment during periods it is unable to obtain drilling contracts, without generating FPHCI.[130]

4. A CFC may also exclude rental income from property which is leased "as the result of the performance of marketing functions" by the CFC. Such marketing functions must be performed by employees of the CFC located in a foreign country. The CFC must maintain and operate in that country an organization that is regularly engaged in marketing the leased property.[131] This organization must be substantial in relation to the rents derived from the relevant leases.[132] The theory is that a CFC that incurs costs which are sub-

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129. TREAS. REG. §1.954-2(d)(1)(ii)(a) (2), T.D. 6784, 1965-1 C.B. 344. *Compare*, TREAS. REG. §1.943-2(d)(1)(ii)(c), Ex. (5) and Ex. (4), T.D. 6784, 1965-1 C.B. 344.

130. TREAS. REG. §1.954-2(d)(1)(ii)(a)(3), T.D. 6784, 1965-1 C.B. 344; TREAS. REG. §1.954-2 (d)(1)(ii)(c), Ex. (6), T.D. 6784, 1965-1 C.B. 344.

131. Such an organization is probably the rough equivalent of an office or permanent establishment. *See* I.R.C. §864(c)(4)(B)(iii) and responsive regulations.

132. TREAS. REG. §1.954-2(d)(1)(ii)(a)(4), T.D. 6784, 1965-1 C.B. 344; TREAS. REG. §1.954-2 (d)(1)(ii)(c), Ex. (3), T.D. 6784, 1965-1 C.B. 344.

The regulations provide a safe harbor to aid in the determination whether the organization referred to in the fourth category is "substantial" in relation to the amount of rental income received by it. TREAS. REG. §1.954-2(d)(1)(i) (1964). There is a similar procedure required by §543(b)(2)(A) and PROPOSED TREAS. REG. §1.543-12(c) (1968) for computing the adjusted ordinary gross income from rent of a domestic personal holding company. Assuming (1) that a CFC derives rental income from property leased as the result of the CFC's performance of "marketing functions," a term which is not defined; (2) that these functions are performed by employees of the CFC who are located in the same foreign country in which there is an organization of the CFC; and (3) the organization is regularly engaged in the business of marketing or marketing and servicing the leased property, then, in the case of the leasing of personal property, an organization will be considered substantial if certain expenses attributable to the organization exceed a formula threshold. This safe harbor formula is to be computed in the following manner:

(1) All expenses properly allocable to the relevant rental income which would be allowable as deductions to the lessor under §162 are totalled;
(2) Any amounts entering the total which represent:
  (a) deductions attributable to compensation paid to related persons or shareholders of the CFC for personal services;
  (b) deductions attributable to rental payments; and
  (c) deductions allowable to the lessor under any section other than §162 (*e.g.*, §167, §163, and §164(b)(4) (foreign taxes)) are aggregated;
(3) The figure from (2) is subtracted from the figure from (1);

stantial relative to gross rentals (as modified)[133] is engaged in substantial maintenance or operational activities and therefore qualifies as an active business. However, the fact that an organization is substantial will be irrelevant if the CFC does not engage in marketing or service functions with respect to the rented property.

Rental income which falls within any of the four categories is excludible from FPHCI. The determination of whether an item of rental income is within one of these categories is generally made with reference to the "facts and circumstances of each case."[134]

The regulations provide similar standards for determining whether royalty income may be excluded:

1. Royalties are derived in the active conduct of a trade or business when such royalties are attributable to the licensing of property which the licensor has developed, created, or produced, or to which substantial value has been added, provided that the licensor is regularly engaged in this activity and is not dealing with a related person.[135] This exception closely parallels the first rental category.[136] Marketing functions are not taken into account in the consideration of activities that add substantial value. Again, regulations responsive to section 954(d) may provide some guidance as to the activities which would constitute development or creation, although the underlying property here is an intangible rather than goods.[137]

A CFC that operates its own research facility with a staff of employees is free to license patents developed by that facility without generating FPHCI.[138] A CFC that purchases patents but employs a staff of technicians who develop processes or equipment which make the patent commercially profitable may also exclude royalties paid on the licensing of such patents.[139] The activity of developing commercial applications for "raw" patents may add substantially to the value of such patents. However, a CFC that merely finances inventors in return for an interest in any patents developed does not qualify, even if it engages in marketing efforts designed to increase the profitability of such patents after they have been obtained.[140]

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(4) A second computation is performed by deriving gross rental income of the CFC and reducing it by:
(a) rents paid or accrued by the CFC, and
(b) deductions allowable under §167. TREAS. REG. §1.954-2(d)(1)(ii)(b)(2), T.D. 6784, 1965-1 C.B. 344.

The CFC achieves the safe harbor with respect to the substantiality of its organization if the figure from (3) is an amount equal to 25% or more of the amount from (4). *Id.*

133. See note 132 *supra*. The activities of an independent contractor are not taken into account in determining whether an organization exists in a foreign country. However, once the existence of such an organization is established, amounts paid by a CFC to an independent contractor enter into the safe harbor computations outlined above.

134. TREAS. REG. §1.954-2(d)(1)(i) (1964).

135. TREAS. REG. §1.954-2(d)(1)(iii)(a)(1), T.D. 6784, 1965-1 C.B. 344.

136. See text accompanying notes 125-128 *supra*.

137. TREAS. REG. §1.954-2(d)(1)(i) (1964). See text accompanying note 126 *supra*.

138. TREAS. REG. §954-2(d)(1)(iii)(c), Ex. (1), T.D. 6784, 1965-1 C.B. 344.

139. *Id.*, EX. (3).

140. *Id.*, EXS. (2) & (4).

2. Royalties will also be considered as derived in the active conduct of a trade or business if such royalties are derived from property which is licensed as the result of marketing functions performed by the licensor. This rule applies only if the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing or marketing and servicing the licensed property, and if such organization is substantial in relation to the amount of royalties derived in the licensing of such property.[141] For example, a CFC that maintains an organization of employees for the purpose of marketing musical compositions, the rights to which the CFC acquires by license, may qualify for the exception if the activity of the organization is substantial relative to the income generated by exploitation of those rights.[142] This exception obviously tracks the fourth rental category[143] and, in fact, the method of qualifying under this provision is basically the same as that with respect to rentals.[144]

Related Persons Exceptions

All the exceptions created by section 954(c) which have been examined to this point have required as a condition to their applicability that the income producing transaction involve persons other than related persons within the meaning of section 954(d)(3). An entity may be a related person with respect to a CFC in one of three ways. An individual, corporation, partnership, trust, or estate is related to a CFC if it controls[145] the CFC. A corporation and a CFC under common control are related. Finally, a corporation controlled by a CFC is related to that CFC.[146]

Section 954(c)(4) creates three additional exceptions which apply only if the income producing transaction involves a related person. The policy underlying all three exceptions is a Congressional determination that United States shareholders of a CFC should not be penalized for conducting activities through a number of entities as opposed to only one.[147] Certain dividends, interest, and

141. TREAS. REG. §1.954-2(d)(1)(iii)(a)(2), T.D. 6784, 1965-1 C.B. 344.

142. TREAS. REG. §1.954-2(d)(1)(iii)(c), Ex. (5), T.D. 6784, 1965-1 C.B. 344.

143. See text accompanying notes 131-132 *supra*.

144. A safe harbor is available for demonstrating that an organization is substantial, and qualification involves the same formula and the same 25% test. See text accompanying note 132 *supra*. The difference is that instead of substracting rental payments in the computations, royalties paid or accrued are not taken into account. TREAS. REG. §1.954-2(d)(1)(iii)(b)(2), T.D. 6784, 1965-1 C.B. 344. The treatment with respect to independent contractors is also the same. A contractor will not cause an organization to exist, but amounts paid to such a contractor are qualified expenses. TREAS. REG. §1.954-2(d)(1)(iii)(b)(3), T.D. 6784, 1965-1 C.B. 344.

145. Control is defined as "the ownership, directly or indirectly, of stock possessing more than 50% of the total combined voting power of all classes of stock entitled to vote." The rules of §958 apply in determining ownership. I.R.C. §954(d)(2). *See* TREAS. REG. §1.954-1 (e)(1)(i) (as to individuals) and (ii) (as to corporations) (1978).

146. *See* S. REP. No. 1881, *supra* note 14, at 3386. *See also* L. Lokken, *supra* note 3, at 136. To the extent such amounts reflect passive income of the related person, they are exposed to operative rules directly under Subpart F and III-G. If those rules are triggered, the income will be taxed from the level actually earned and are thus immunized from a further tax in any event. See text accompanying note 36 *supra*. *See also* I.R.C. §959(b).

147. *See* S. REP. No. 1881, *supra* note 14, at 3386. *See also* L. Lokken, *supra* note 3, at 136. To the extent that such amounts reflect passive income of the related person, they are exposed

royalties which have the appearance of passive income when viewed in the abstract may actually reflect the earnings of an operating subsidiary or other related entity. The Congressional objective is to exclude such payments from FPHCI. Such amounts would reflect earnings from an active business if the activity were conducted within the CFC's corporate shell. Their character is not changed for Subpart F purposes because the actual operations are undertaken by a separate entity and funnelled to the CFC in the form of dividends, interest, rent, or royalty payments. Each of the three exceptions will be examined separately.

Section 954(c)(4)(A): Same Country Interest and Dividends

FPHCI does not include interest and dividends received from a related person created or organized under the laws of the same foreign country as the CFC, provided a substantial part of the assets of the related person are used in its trade or business located in such foreign country. This exception is as broad as any in section 954(c), because it applies to all CFCs that receive dividends or interest from a related person, regardless of the nature of the business, if any, conducted by the CFC. Thus, a CFC that is merely a holding company for several operating companies may have no FPHCI even though its entire income consists of interest and dividends.

When a CFC receives interest or dividends from an operating company that is in a control relationship with the CFC, the involvement of two legal entities rather than one is of no economic significance. Congress concluded that when the CFC and related person were simultaneously residents of the same country in which the related person maintained substantial assets, little opportunity to manipulate transactions between the related entities in a manner which would improperly avoid taxation would arise. The presence of substantial business assets increases the probability that the related person is an operating company. Such payments therefore constitute only a first step in the repatriation of earnings which would not have been subject to United States tax had the related person simply retained them.[148]

The language of the Code is ambiguous in one important respect. It does not clearly require that a substantial part of *all* assets of the related person be located in the same country in which it and the CFC are organized. The Code requires that the related person maintain "a substantial part of its assets used in its trade or business" in such country. Read liberally in favor of the CFC, this

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to operative rules directly under Subpart F and III-G. If those rules are triggered, the income will be taxed from the level actually earned and thus are immunized from a further tax in any event. See text accompanying notes 33-37 *supra*. *See also* I.R.C. §959(b).

148. Neither the committee reports nor the regulations provide much guidance. The policy articulated by S. REP. No. 1881 (see note 14 *supra*) indicates there should be no inclusion of amounts received by a CFC from a related person "where the U.S. shareholder would not have been taxed if he had owned the stock of the related party [sic] directly." Taken literally, of course, this statement is nonsense, because a United States shareholder would always be taxed on amounts of gross income distributed by a foreign corporation. Probably what is meant is that if the United States shareholder owned the shares directly there would be no need to pass the funds through the CFC, and thus no Subpart F inclusion.

language can be interpreted to require that only a substantial part of the *assets used in the trade or business* of the related person be located in the proper country. The Treasury could also have reasonably taken the position that a substantial part of *all the assets* of the related person must be located in the proper country, and, in addition, that such assets be used in its trade or business. The legislative history provides no guidance on this matter. The Treasury, however, has interpreted the language as focusing only on the business assets of the related person. The extent of the non-business assets of the related person is not taken into account.[149]

The Treasury's rules interpreting this exception are among the most complex of the Subpart F regulations. A showing that the exception applies involves timing, situs, and valuation problems. The CFC and related person must both be organized under the laws of one foreign country in the year that interest or dividends are received and also, in the case of dividends, in the year in which the earnings and profits that gave rise to such dividends were earned by the related person. The same dual timing requirement must be satisfied with respect to the location of trade or business assets of the related person.[150] Business assets are those which contribute directly or indirectly to the income earned in the trade or business of the related person. Determining whether a "substantial part" of such assets are located in the proper country at the proper time involves a facts and circumstances analysis.[151] There is, however, a safe harbor available if, for each quarter of the year, the average value of the business assets located in the relevant country constitutes 80 percent of the average value of all the business assets of the related person[152] for that period.

The regulations speak in terms of "the trade or business" of a related person. Apparently no consideration was given to the possibility that a related person might conduct more than one trade or business. A related person that cannot pass the 80 percent test after aggregating its various businesses should be entitled to exclude at least the ratable part of the interest and dividends received from a related person attributable to a qualified business. Since the related person could probably sever such a business into a separate entity, this view seems consistent with a Congressional policy equalizing the tax effect of Subpart F on economic enterprises regardless of their form.[153]

149. *See* TREAS. REG. §1.954-2(e)(1)(i) (1964). "Whether a substantial part of the assets *used by a foreign corporation in a trade or business* will be considered to be located in the country . . . will depend on the facts and circumstances of each case." (Emphasis added).

150. TREAS. REG. §1.954-2(e)(1)(i) (1964).

151. *Id.* See note 149 *supra.*

152. The regulation speaks here only with reference to a related person which is a foreign corporation. However, neither the Code nor the regulations so limit the exception in other contexts and there is no reason why any related person that satisfies the test should fail to qualify for the exception. *See* TREAS. REG. §1.954-2(e)(1)(i) (1964); TREAS. REG. §1.954-1(e)(1) (1964). However, one difficulty arises with the language of the Code, which uses the term "created or organized" when referring to the related person. I.R.C. §954(c)(4)(A). S. REP. No. 1881, *supra* note 14, refers only to a "related party" which is a foreign corporation. It would therefore be possible for the government to restrict the application of the exception accordingly. The term "related person" used in the remainder of the discussion of this exception should therefore be read with that caveat.

153. See note 147 *supra.* But see note 152 *supra.*

A related person, regardless of its method of accounting, is required to value all assets at their actual value, unreduced by liabilities. In the absence of affirmative evidence to the contrary, this value is deemed to be the adjusted basis of such assets.[154] Prior to 1962, however, CFCs had no reason to keep records from which an "adjusted basis" for purposes of United States tax law could be derived. In addition, there is a fundamental problem with computing such a basis under the terms of the Code. In general, upward and downward adjustments in basis are made in tandem with the tax effect of the transaction precipitating the adjustment.[155] Depreciation is required to be subtracted from basis when depreciation is allowable as an income reducing expense.[156] Capital improvements require an upward adjustment because such amounts represent costs to the enterprise not allowable as current deductions.[157] A foreign corporation is ordinarily not subject to United States tax, and consequently needs and takes no deductions of any kind. The rules pertaining to adjustments in basis are not literally applicable to CFCs. However, the regulations seem to contemplate that such adjustments should be made.[158] Finding authority for this requirement may involve a bootstrapping operation from section 954(c) into section 553 or section 964. Because a CFC is required to put itself in the place of a domestic holding company, to which the adjustments do apply.[159] It is not objectionable to require the CFC to pretend that it has been subject to tax for prior years, and that such deductions have been taken. The question remains as to whether special rules such as those permitting accelerated depreciation apply in this context.[160] The better view is that accelerated depreciation should not be available. The fundamental inquiry is directed to the "actual value" of all assets, and artificially accelerated depreciation schedules bear little or no relationship to changes in real values.

Certain intangibles are valued in a slightly different manner. A related person on the accrual method follows the principles outlined above. Intangibles are valued at their adjusted basis in the absence of an affirmative showing that their value is different. Related persons using the cash method are required to value receivables and open accounts at face without an allowance for uncollectible accounts. However, the fundamental inquiry is directed to the actual value of all assets, so that a different value can be used if accompanied by affirmative evidence that the amount claimed is correct.[161]

The final factor to be considered is the situs of the property. Fixing the situs of real and tangible personal property at any point in time ordinarily

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154. TREAS. REG. §1.954-2(e)(1)(i) (1964). See text accompanying note 161 *infra*.

155. *Cf.*, I.R.C. §1016. Congress was aware of Subpart F ripples here. I.R.C. §1016(a)(19).

156. I.R.C. §1016(a)(2).

157. I.R.C. §1016(a)(1).

158. *See* TREAS. REG. §1.964-1(b)(1)(ii), T.D. 6787, 1965-1 C.B. 354; TREAS. REG. §1.954-2 (e)(1)(i) (1964).

159. TREAS. REG. §1.964-1(a) (1964); TREAS. REG. §1.954-2(a) (1964); TREAS. REG. §1.553-1 (1964). See text accompanying note 50 *et. seq. supra*. TREAS. REG. §1.964-1(a) (1964) requires depreciation adjustments to the CFC's earnings and profits.

160. *See* I.R.C. §167(b).

161. TREAS. REG. §1.954-2(e)(1)(i) (1964).

presents no particular difficulty.[162] Real property is located in the country where it exists. Leaseholds, improvements, and mortgages, as well as mineral, oil, and gas interests, are always located at the situs of the underlying reality.[163] Tangible personalty is usually considered as located where it is customarily kept. Vehicles and other moveable personalty are probably located at their tax situs under local law. In the event local laws conflict, perhaps allocation would be proper.[164] Property, other than inventory and stock in trade, purchased outside the country where the related person is created or organized will nevertheless be considered as located in such country as of the date of purchase if the property is shipped there promptly thereafter.[165]

The situs of intangibles presents somewhat more complex problems. Intangibles having a nexus with certain real property have already been noted.[166] The regulations subdivide other types of intangibles into several different categories. Receivables of any kind reflecting a nexus with the country in which the CFC and related person are organized are deemed located in that country and are also considered trade or business assets. For example, a receivable arising from the rental of property, the performance of personal services, or from the sale of property manufactured, grown, or extracted in the country in which the related person is organized will be considered a trade or business asset located in such country, provided the aggregate of obligations owed to the related person and owed by the obligor are ordinary and necessary to the business of both parties. Regardless of the relation of the related person, a transaction will be considered ordinary and necessary only if it would be so between two unrelated parties dealing at arm's length.[167] Receivables which are of the type generally encompassed by this category but which fail to satisfy the ordinary and necessary requirement may not be counted to satisfy the substantial assets test. However, they should not be considered trade or business assets unless they actually are such.[168]

Other receivables are grouped according to whether the obligor is an individual or other entity. If the obligor is an individual who is a resident of the country of organization only, receivables and open accounts which do not arise out of transactions reflecting a nexus with such country will nevertheless be considered as trade or business property located in the country of organization.[169] Obligations owed by other individuals will not be considered located in

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162. As the discussion below indicates, the matter is not without certain difficulties. The regulations, however, provide no guidance on the issue of moveable tangible personalty.

163. TREAS. REG. §1.954-2(e)(1)(ii)(b) (1964).

164. *Cf.*, I.R.C. §954(c)(4)(C); TREAS. REG. §1.954-2(e)(3) (1964). See text accompanying note 195 *infra.*

165. TREAS. REG. §1.954-2(e)(1)(ii) (1964).

166. See text accompanying note 163 *supra.*

167. TREAS. REG. §1.954-2(e)(1)(ii)(a) (1964).

168. It is not certain that regulations written under the heading "Location of Assets" were intended to convert non-business intangibles into business assets, yet that appears to be the result. It is more likely that the Treasury was attempting to resolve the issue of when receivables are "used" instead of merely "held." The Code language requires "use."

169. TREAS. REG. §1.954-2(e)(1)(ii)(b)(1) (1964).

such country, but, again, should be considered business property only if they are such in fact.[170]

If the obligor is an entity other than an individual, there is a further division based on whether the obligor is related or unrelated to the person making the payment of interest to the CFC. If the obligor is an entity other than an individual – for example, a corporation – and is a related person with respect to the obligee, receivables which do not show the proper nexus with the country of organization will be considered as located in such country only if the obligee satisfies a gross income test. This gross income test should not be confused with the safe harbor provision discussed earlier.[171] The safe harbor permits a related person to demonstrate that a substantial part of its business assets are in its country of organization. In satisfying this test, the related person must value and fix a situs for its intangible business assets. However, receivables that generally fall within the category now under discussion will be considered located in the proper country only if the obligor derives 80 percent or more of its gross income for the three-year period ending with the year in which the obligation is incurred from sources within the country in which the obligee is organized. The source rules of sections 861-863 are to be applied in this context with the country in which the related person/obligee is organized taking the place of the United States in the language of the statutes.[172] The United States source rules rely heavily on passage of legal title in identifying the source of income from transactions involving sales of goods and do not always designate the situs which has the greatest economic nexus with the transaction.[173]

If the obligor is other than an individual and is unrelated to the obligee, the test which is applied is substantially the same as the one above. The difference is that the CFC (in the interest of which the related person/obligee is required to determine the nature and sources of income of its obligor) is entitled to rely on "ascertainable facts" in formulating a reasonable belief that the obligor satisfies the gross income test outlined above.[174] The reason for this distinction is that the CFC may not be in a position to require the obligor to reveal the amounts and sources of its income. This is not the case where the CFC, the related person paying interest or dividends to the CFC, and the obligor indebted to the related person are all under common control. The extent of any duty to unearth these "ascertainable facts" is unclear, but the language of the regulation clearly requires the CFC to form this reasonable belief as to the obligor of every receivable it wishes to count as a properly situated business asset of the related person.[175] Obligations of an obligor that cannot satisfy the gross income test cannot be counted toward qualification under this exception.

An intangible held by a related person not covered by any of the rules discussed to this point may still be partially includible in property aggregated to

170. See text accompanying note 168 *supra.*
171. See text accompanying note 152 *supra.*
172. I.R.C. §§861-863; TREAS. REG. §1.954-2(e)(1)(ii)(b)(2) (1964).
173. I.R.C. §§961-963; TREAS. REG. §1.861-7(c) (1957). *See* L. Lokken, *supra* note 3, at 34-35.
174. TREAS. REG. §1.954-2(e)(1)(ii)(b)(3) (1964).
175. *Id.*

satisfy the substantial assets test. However, such intangibles must actually be trade or business assets. Receivables properly situated under the other rules are automatically considered as business assets as a result of their situs. The amount includible from this residue is determined under the following ratio.

$$\frac{\text{Includible Business Intangibles from Residue}}{\text{All Business Intangibles from Residue}} = \frac{\text{Tangible Property and Intangibles Deemed in Proper Country}}{\text{All Business Property Wherever Situated}}$$

The excess of such amounts is excluded.[176]

To summarize, the assets of each individual or other entity related to a CFC must be identified, valued, and given a situs. In order to exempt interest and dividends paid by any related person to a CFC, the CFC must demonstrate that a substantial part (80 percent satisfies the safe harbor) of the assets used by the related person are located in the country in which both the CFC and related person are created or organized. Dividends or interest paid by a related person failing to qualify may not be excluded from FPHCI under this exception.

One further complication remains to be noted. With respect to interest, demonstration by the CFC that the related person satisfies the statutory tests in each year interest is received by the CFC is sufficient. However, in the case of dividends, the CFC must also show that the statutory tests were satisfied during the years the earnings and profits distributed by the related person to the CFC were accumulated.[177] Section 954 does not specifically require this showing. In fact, that section does not concern itself with timing problems at all.[178] The showing required by the regulations is probably designed to preclude a related person from accumulating a large surplus during years when the statutory tests could not be satisfied and dumping out large dividends in a year during which the related person is temporarily restructured to comply with the statute. The need for such a provision is questionable, however. Subpart F already contains mechanisms designed to reach lower tier CFCs[179] and brother-sister corporations under its general rules.[180] To the extent the earnings of such an entity are profits from an active business, they should not create income when distributed to the parent.[181] It is doubtful that the double timing requirement applied to dividends serves any useful purpose.

There is imposed, nevertheless, a tracing test, carrying with it the attendant complications. The regulations responsive to Subchapter C should be applied to identify the relevant earnings and profits and to answer other questions which arise in this context.[182] However, in order to ease the burden on the accounting departments of CFCs and their related persons for years prior to

176. TREAS. REG. §1.954-2(e)(1)(ii)(b) (1964).
177. TREAS. REG. §1.954-2(e)(1)(i) (1964).
178. *See* I.R.C. §954(c)(4)(A).
179. I.R.C. §§958, 951(b), 959(b). See text accompanying notes 36-37 *supra*.
180. I.R.C. §§958, 951(a).
181. See text accompanying notes 147-148 *supra*.
182. *See* I.R.C. §§312, 316, 301. *Cf.*, TREAS. REG. §1.964-1, T.D. 7545, 1978-24 I.R.B. 20.

the enactment of Subpart F, the regulations require only that the two entities be related at the pertinent times and that the other requirements be "substantially satisfied."[183] The meaning of this apparent relaxation of the rules is uncertain. There are only two requirements beyond relatedness. First, the two entities must show a common country of creation or origin; second, a substantial part of the assets of the related person must be located in that country at the proper time. Instances in which a CFC could substantially comply with the first requirement without meeting the letter of the law would be rare. The second requirement already contains the word substantial. Syntactically, the provision must be read to require a "substantially substantial" part of the related person's assets be in the relevant country at the proper time. Perhaps what is meant is that the timing rules will be relaxed, or perhaps only substantial compliance with the various 80 percent tests will be required.

Section 954(c)(4)(B): Interest Paid by a Related Person Conducting a Banking or Financing Business

The second exception applicable exclusively to payments received from an entity related to a CFC permits the exclusion of interest paid to a CFC engaged in the banking, financing, or similar business by a related person that conducts a similar business. However, the exception is available only if both organizations conduct business predominantly with persons other than related persons.[184] This exception supplements the exclusion available to banking institutions discussed earlier.[185] The exception for banking institutions does not extend to payments received from related persons. The related person provision expands the scope of the banking institution exclusion but is limited in two respects. First, this exception does not reach dividends or gains from securities transactions; second, it applies only to related persons conducting a banking, financing, or similar business. Therefore, unless the exception under section 954(c)(4)(A) applies,[186] dividends and securities gains attributable to transactions with related persons engaged in the banking business are not excludable. Similarly, no exclusion will be permitted for interest, dividends, or securities gains paid to a banking CFC by a related person engaged in a business other than banking or finance. When the exception does apply it exempts interest payments without regard to the location of the business assets or the country of organization of the payor-related person.[187]

The same definition as in section 954(c)(3)(B) of a banking, financing, or similar business applies.[188] The business of the recipient CFC and the related person-obligor will be considered predominantly with unrelated persons if each receives more than 70 percent of its gross income for the taxable year from unrelated persons.[189] The test is applied separately to the related person in its tax

183. TREAS. REG. §1.954-2(e)(1)(i) (1964).

184. I.R.C. §954(c)(4)(B); TREAS. REG. §1.954-2(e)(2) (1964).

185. I.R.C. §954(c)(3)(B). See text accompanying notes 106-112 *supra*.

186. See text accompanying note 147 *supra*.

187. *Cf.*, I.R.C. §954(c)(3)(A).

188. TREAS. REG. §§1.954-2(e)(2), 1.954-2(d)(2), T.D. 7497, 1977-2 C.B. 257. See text accompanying notes 107-109 *supra*.

189. TREAS. REG. §1.954-2(e)(2), T.D. 7497, 1977-2 C.B. 257.

year in which amounts are paid and to the CFC in its tax year in which amounts are received. The regulations do not specify how two entities not subject to United States tax should determine their tax years, but presumably any method consistently applied from year to year would be acceptable.

The regulations contemplate that a related person should aggregate its activities, in the event that it conducts more than one trade or business, to determine whether it is primarily engaged in a banking or financing business.[190] A related person will be considered as primarily engaged in a banking or financing business if more than 50 percent of its gross income for the tax year is attributable to such business.[191] The Code does not literally require that a related person be engaged "primarily" in a banking business, making available the exception for interest paid by a "related person engaged in the conduct of a banking, financing, or similar business."[192] The committee report indicates, however, that Congress intended the exception to apply only to "related financial institutions."[193] A related person that derived a substantial part of its revenues from activities other than banking and finance would probably not be considered a financial institution within the intent of Congress. However, the 50 and 70 percent limitations discussed above should probably be viewed as safe harbors rather than fixed and certain standards.

Section 954(c)(4)(C): Rents and Royalties Received from a Related Person for Use of Property Within the CFC's Country of Origin

The final related persons exception excludes from FPHCI certain amounts received as rents, royalties and similar amounts paid to the CFC for the use of or right to use property within the country in which the CFC is organized. The situs restriction is imposed to limit transactions artificially structured to avoid tax at the source of the economic activity. The term "similar amounts" is not defined by the regulations but probably is intended to extend the exception to payments made for the use of the CFC's property, tangible or intangible, regardless of how such payments are labelled for purposes of local law. Amounts are excludible only to the extent the payment is for the use of property within the country in which the CFC is organized.[194] In the event property is used in more than one country, a reasonable allocation between the value of use within and use without is necessary. In the event that questions arise concerning the location of rented assets, the situs rules applicable to section 954(c)(4)(A) may provide some guidance.[195]

DEDUCTIONS

After the items of income of a CFC have been identified as FPHCI and the various exceptions applied to exempt items which fall within them, the remain-

190. *Id.*
191. *Id.*; *cf.*, TREAS. REG. §1.964-1(c), T.D. 7545, 1978-24 I.R.B. 20.
192. I.R.C. §954(c)(4)(B).
193. S. REP. No. 1881, *supra* note 14, at 3386.
194. I.R.C. §954(c)(4)(C); TREAS. REG. §1.954-2(e)(3) (1964).
195. *See* TREAS. REG. §1.954-2(e)(1)(ii) (1964).

ing sum is added to the other components of foreign base company income and eventually becomes a part of Subpart F income.[196]

This sum is not, however, taxed *in toto* to the CFC's group of United States shareholders. Section 954(a)(1) provides that deductions allowable under section 954(b)(5) are available to reduce the amount constituting Subpart F income.[197] Subpart F does not modify the general rules applicable to deductions in the context of foreign operations of United States persons. The regulations incorporate the detailed rules developed under section 882(c).[198] Deductions are allocated into groupings related to various classes of income. Excess deductions generally carry over ratably to other classes.[199]

CONCLUSION

While submerged in the FPHCI regulations, the simplicity of Congress' intent with respect to section 954(c) is obscured. The inclusion of FPHCI in foreign base company income is merely intended to deny the deferral privilege to items of passive income earned by CFCs when such income would otherwise be taxed at rates substantially below the United States rate. For sound policy reasons Congress carves out exceptions for finance, banking, and insurance companies on the premise that the nonmanipulative conduct of an active business should not be affected by Subpart F. There is also an attempt to minimize the distinctions between a business that operates an integrated enterprise from within a single corporate shell and an identical enterprise that is divided into a parent and a series of separate subsidiaries. Although there are sound reasons in support of these provisions, applying them often results in complexities which reach absurd levels.

Reform of the tax law to accomplish with greater simplicity the precise objectives defined by Congress is probably not possible. However, the reach of Subpart F is actually rather limited. Subpart F was primarily intended to sweep in foreign corporations controlled by publicly held domestic corporations. A foreign corporation controlled by as few as six unrelated entities may be entirely beyond the reach both of Subpart F and III-G.

Precise identification of items of income as required by Subpart F seems questionable when the means of identifying the entities which are subject to its rules are drafted so generally. Assuming that in defining the CFC Congress has successfully identified the most flagrant abusers of the deferral privilege, the administrative expense to a United States controlled foreign corporation may

196. I.R.C. §§954(a), 952(a)(2).

197. I.R.C. §§954(a)(1), 954(b)(5); TREAS. REG. §1.954-1(c) (1964).

198. I.R.C. §882(c); TREAS. REG. §§1.882-1, T.D. 7293, 1973-2 C.B. 228; 1.882-2, T.D. 7293, 1973-2 C.B. 228; 1.882-3, T.D. 7293, 1973-2 C.B. 228; 1.882-4 (1957). *See* L. Lokken, *supra* note 2, at 52-55.

199. TREAS. REG. §1.861-8, T.D. 7456, 1977-1 C.B. 200. A detailed discussion of the allocation procedure is beyond the limited scope of this note. However, a CFC is clearly not entitled to the dividend deduction available to a domestic corporation, since this would clearly frustrate the goal of reaching passive income. Since the CFC pays no U.S. tax, there is no double tax problem such as the one which motivated Congress to enact I.R.C. §§243, 245. *See* L. Lokken, *supra* note 3, at 117-20.